



HM TREASURY

Unlimited Insurance companies

A consultation document

April 2004

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ISBN: 1-84532-019-0

UNLIMITED INSURANCE COMPANIES

PREFACE

This consultation document seeks views on a draft Bill to protect certain members of unlimited insurance companies that are insolvent.

Draft clauses on proposed legislative provisions for the options discussed are at *Annex A*.

A partial Regulatory Impact Assessment is attached at *Annex B*.

The Treasury would be grateful for any comments on the proposed clauses or on the partial Regulatory Impact Assessment to be sent by 9 July 2004 to the following address:

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Please could respondents give details of any organisation whose views they represent.

Unless respondents indicate to the contrary, it will be assumed that they have no objection to their response being made public.

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INTRODUCTION

In her statement to the House of Commons on 8 March 2004, at the time of the publication of the Penrose Report on Equitable Life Assurance Society (ELAS), Ruth Kelly, the Financial Secretary to the Treasury, announced that as the report raised a number of issues concerning the unlimited liability status of ELAS the Treasury intended to publish and consult on draft legislation to protect policyholders in the event that ELAS's unlimited status were ever to become material.

This consultation document covers draft clauses which deal with the issue of unlimited liability which could potentially affect certain policyholders of ELAS and a small number of other companies.

The unlimited nature of any insurance company will generally be material for members only in an insolvency. The Board of ELAS have emphasised that the Society remains solvent.

In the light of recent developments in European law relating to insolvent insurers¹ and the possible consequences of the interaction of ELAS's constitution as an unlimited company with that new European law, the Treasury consider that it would be appropriate to review the position of members of unlimited insurance companies. It has also undertaken to consult on legislation to protect them from any adverse consequences of the insolvency of their insurer.

The Treasury welcome comments on all aspects of the issues raised in this consultation document. Comments are requested by 9 July 2004.

¹ Directive 2001/17/EC of the European Parliament and of the Council of 19 March 2001 on the reorganisation and winding-up of insurance undertakings. (OJ No. L 110, 20.4.2001, p28).

UNLIMITED LIABILITY AND EQUITABLE LIFE ASSURANCE SOCIETY

Introduction

ELAS is incorporated as an unlimited company. It also operates on a mutual basis. This means that those policyholders who have policies in the with-profits fund are also the members of the company. One potential consequence of that is that members could be liable to contribute to the funds of the company through “calls” made by the company in the event that the company were to become insolvent.

ELAS is very unusual, although not unique, in being incorporated on an unlimited basis.

There is real doubt over whether policyholders of ELAS (or any other unlimited insurance company) would actually be liable to calls in the event of any insolvency. Any liability would be likely to arise because of an unintended effect of the Insurers’ Reorganisation and Winding-up Directive (2001/17/EC)² (“the IRWD”), which may serve to undermine provisions in the company’s constitution³ that should have prevented calls being made against members. This is discussed further below.

Taking these factors into account, Treasury Ministers do not believe that it would necessarily be just that members of an unlimited liability insurer should be exposed to the risk that calls could be made against them. The Treasury therefore proposes to bring forward, when Parliamentary time allows, legislation which confers a discretion on the Financial Services Authority (FSA) to give a direction in certain circumstances which extinguishes the liability of contributories to have calls made on them and the liability to meet any calls which have been made.

² This Directive was originally transposed into UK law by The Insurers (Reorganisation and Winding-up) Regulations 2003 (S.I. 2003/1102). These have recently been amended and replaced (to take account of the Enterprise Act 2002) by The Insurers (Reorganisation and Winding-up) Regulations 2004 (S.I. 2004/353).

³ Article 4 – reproduced below.

Existing protection for members of ELAS

The company's constitution contains a provision which is intended to protect members from the risks of unlimited liability. Article 4 of ELAS's Articles of Association states:

'Every Policy shall be granted by the Society on the terms that the Society shall only be liable thereunder to the extent of its assets and property from time to time existing, and that no Member of the Society, and no other person who is at any time in any way interested in any Policy, shall be liable to any call or contribution, whether in any liquidation of the Society or otherwise howsoever, for satisfying any claim or demand under or in respect of the Policy so granted, whether by the grantee thereof or by any other person for the time interested therein.'

The validity of such clauses, as a means of limiting an unlimited insurer's liability under such policies and of restricting the liability of members, is recognised in section 74(2)(e) of the Insolvency Act 1986.

However, the meaning and practical effect of the first part of this article is subject to several different interpretations, and its effect may have been altered by the recent implementation of the IRWD. In the event of an application to commence insolvency proceedings, the meaning of the company's constitution and the effect of the implementing legislation could only be definitively settled by a court judgment, but the two constructions that the Treasury consider to be the most likely to be adopted are set out and discussed below:

- a) That Article 4 requires non-policy debts to be deducted from the fund before policies are valued, and the total value of these policies can never exceed the remaining value of the fund (i.e. policy values are reduced in line with available assets); or
- b) That Article 4 requires non-policy debts to be paid before policy claims are paid, but this does not impact on the contractual value of policies.

The construction at (a) would, in practice, mean the company can always meet all of its non-policy debts in full (at the expense of declining contractual policy values) and so would never have cause to make calls.

In the event that the court preferred this interpretation, the value of policies would be reduced in line with assets. However, policyholders would be protected by the rules of the Financial Services Compensation Scheme (FSCS), which require the FSCS to pay compensation on the basis of policy values prior to any reduction arising from this operation of Article 4.

In order for calls to be made on members, the court would have to favour the construction at (b), which provides that non-policy claims should be prioritised. This would be inconsistent with the IRWD and the UK's implementing legislation, which requires that, on a winding up of any insurer, "insurance claims/debts"⁴ must take priority over other general debts of an insurance company.

The court would therefore be likely to strike down the first part of Article 4 (which provides that non-policy debts be paid first) on the basis that it was inconsistent with the requirements of the IRWD.

The consequence of this would be that insurance claims/debts are paid first, with other debts being subordinated to them.

This may negate the protection offered to members in the second limb of article 4 (that calls cannot be made "for satisfying any claim or demand under or in respect of the Policy so granted"). Whereas on the basis of this interpretation of Article 4, all other debts would

⁴ The directive (article 2(k)) defines insurance claims as 'any amount which is owed by an insurance undertaking to insured persons, policy holders, beneficiaries or to any injured party having direct right of action against the insurance undertaking and which arises from an insurance contract or from any operation provided for in Article 1(2) and (3), of Directive 79/267/EEC in direct insurance business, including amounts set aside for the aforementioned persons, when some elements of the debt are not yet known. The premiums owed by an insurance undertaking as a result of the non-conclusion or cancellation of these insurance contracts and operations in accordance with the law applicable to such contracts or operations before the opening of the winding-up proceedings shall also be considered insurance claims.'

In the implementing regulations (regulation 2(1)) an insurance debt is defined as 'a debt to which a UK insurer is, or may become liable, pursuant to a contract of insurance, to a policyholder or to any person who has a direct right of action against that insurer, and includes any premium paid in connection with a contract of insurance (whether or not that contract was concluded) which the insurer is liable to refund.'

have been paid first, leaving only policy claims to be met – in respect of which members were not liable to contribute – that situation would be reversed, with policy claims being paid first and general creditors left with insufficient funds in the company to meet their claims. The restriction on liability to contribute in Article 4 may therefore not protect members in this case.

Therefore, the reversal of the priority established by Article 4 by the IRWD means that members could now be exposed to the risk of calls to meet these liabilities. This is contrary to the original intention of Article 4.

This is an unintentional side-effect of the IRWD and its implementation into UK law. Therefore, the Government proposes to legislate to give the FSA a discretion in certain circumstances to prevent calls being made against members.

It is proposed that these provisions will apply throughout the United Kingdom.

PROPOSED DRAFT CLAUSES

The draft clauses at Annex A covers the Treasury's proposals for legislation on this issue.

The draft clauses are not specific to ELAS – as noted above the Treasury understand that there is a small number of other unlimited liability insurers. It should be noted that the draft clauses apply only to insurers authorised under Part 4 of the Financial Services and Markets Act 2000 and, therefore, does not apply to participants in Lloyd's of London whose authorisation is achieved by different means. Given this, the clauses are framed in terms of a FSA discretion to exercise a power, as this leaves open the possibility that there might be situations where it is appropriate for members of an unlimited liability insurer to remain liable to calls.

Clause 1 sets out the discretion which is to be conferred on the FSA. This discretion enables the FSA to give a direction to an unlimited insurance company. The direction will extinguish any liability to calls which might be made and any liabilities arising from calls which have already been made (clause 1(2)).

Question 1 – Is giving the FSA a power to extinguish any liability to calls and any liabilities arising from calls which have already been made the most appropriate way of preventing calls being made against certain members of unlimited liability insurers? If not, what are the alternatives?

A direction can only be given (clause 1(1)) where:

- a) The company is insolvent, likely to become insolvent or is in financial difficulties;
- b) It would be unjust in all the circumstances for calls to be met by members of the company; and
- c) It is appropriate for the direction to be given for purposes connected with meeting the FSA's statutory objectives relating to market confidence and/or protection of consumers.

Draft clause 1(3) sets out certain requirements to which the FSA must have regard in deciding whether it would be unjust to allow

calls to be made. The FSA will be required to consider, in particular:

- a) The extent to which members might reasonably be expected to have understood that they might be liable to calls at the time they entered into the relevant transaction;
- b) Anything which has affected the potential liability of members to calls since they entered into those transactions; and
- c) The likely impact on members if no direction were given.

Question 2 – Are these appropriate matters for which the FSA should have particular regard when deciding whether it would be unjust to allow calls to be made. If not, what further or alternative matters would it be appropriate for the FSA to consider?

Draft clause 2 sets out the procedure to be followed by the FSA in giving and publicising directions made under clause 1.

This requires the FSA to consult with the company before giving a direction (clause 2(1)), unless the company itself has applied for the direction and the direction is in the terms applied for (clause 2(2)). A copy of the direction must be sent to the company (clause 2(3)).

The FSA is required to publish the direction as soon as reasonably practicable after it is made (clause 2(5)) and in a way which it thinks most likely to bring it to the attention of those most likely to be affected by it (clause 2(4)).

However, the FSA can withhold publication if it believes that doing so would be detrimental to the interests of the company or the policyholders (clause 2(6)). This may possibly arise in a case where the direction is given to a company in financial difficulties where there is a possibility that these could be overcome and it is considered that publication of the direction could jeopardise this possibility. The FSA must publish the direction at a future time if it considers that it is appropriate to do so.

Question 3 – Are these appropriate procedures for the issue and publication of a direction given under the power set out in the draft Bill? If not, what would be appropriate procedures? Are there any additional procedures needed?

Clause 3 sets out how words and phrases used are to be understood and provides that the FSA's ability to charge fees and its exemption from liability under Schedule 1 to the Financial Services and Markets Act 2000 also apply to the FSA's performance of its functions under this Act.

ANNEX A - DRAFT CLAUSES ON UNLIMITED INSURANCE COMPANIES

1 Power to extinguish liability for calls

- (1) The Authority may give a direction under this section in respect of an unlimited insurance company if it appears to the Authority—
 - (a) that the company is or is likely to become insolvent, or is otherwise in financial difficulty;
 - (b) that it would be unjust in all the circumstances for calls to be met by contributories to the company on whom they have been or (but for the direction) might be made; and
 - (c) that it is appropriate for the direction to be given for purposes connected with meeting the Authority's market confidence objective or its protection of consumers objective, or both.
- (2) A direction under this section in respect of a company extinguishes—
 - (a) the liabilities of contributories to the company to have calls made on them; and
 - (b) their liabilities to meet calls that have been made on them.
- (3) In determining for the purposes of this section whether it would be unjust for calls to have to be met by contributories to a company, the Authority must have regard, in particular, to—
 - (a) the extent to which, at the time persons entered into transactions by virtue of which they became contributories, they might reasonably have been expected to understand that they could, as a result, become liable to meet calls;
 - (b) anything that has affected the potential liability to calls of contributories to the company since they entered into those transactions; and
 - (c) the likely impact on those contributories of calls if no direction under this section were given.
- (4) A direction under this section comes into force at the time specified in it.

2 Procedure for directions under s. 1

- (1) Before giving a direction under section 1 in respect of a company, the Authority must consult the company.
- (2) Subsection (1) does not apply where—
 - (a) the company has applied for the direction; and
 - (b) the direction is in the terms applied for.
- (3) Where the Authority gives a direction under section 1 in respect of a company, it must send a copy of the direction to the company.
- (4) The Authority must also publish a copy of every direction under section 1 in the way it thinks most suitable for bringing it to the attention of persons likely to be affected by it.
- (5) Publication under subsection (4) must be as soon as reasonably practicable after the giving of the direction.

- (6) The Authority is not required to publish anything under subsection (4) the publication of which it considers would be detrimental to the interests of—
- (a) the company in question; or
 - (b) persons who are policyholders of that company.
- (7) Where the Authority—
- (a) in exercise of its power under subsection (6), does not publish the whole or a part of a direction as soon as reasonably practicable after it was given, but
 - (b) at a subsequent time considers that it is no longer appropriate to withhold publication on the grounds specified in that subsection,
- it must, as soon as reasonably practicable after that time, publish whatever was not previously published in the way it thinks is now the most suitable for bringing it to the attention of persons likely to be affected by it.

3 Interpretation and consequential amendments

- (1) In this Act—
- “the Authority” means the Financial Services Authority;
 - “company” has the same meaning as in the Companies Act 1985 (c. 6);
 - “contributory”, in relation to a company, has the same meaning as in the Insolvency Act 1986 (c. 45) (see section 79(1) of that Act);
 - “insolvent”, in relation to a company, is to be construed in accordance with subsection (2);
 - “insurance company” means a company that has permission under Part 4 of the Financial Services and Markets Act 2000 (c. 8) to effect or carry out contracts of insurance;
 - “market confidence objective” and “protection of consumers objective”, in relation to the Authority, have the meanings given, respectively, by section 3 and section 5 of that Act;
 - “policyholder”, in relation to a company, means a person who is a policyholder within the meaning of that Act in relation to any contract of insurance with the company (see section 424 of that Act);
 - “unlimited insurance company” means an insurance company that is an unlimited company.
- (2) For the purposes of this Act a company is insolvent if —
- (a) it has gone into liquidation (within the meaning of the first group of Parts of the Insolvency Act 1986 (c. 45) (see section 247 of that Act)); or
 - (b) there is otherwise an insolvency in relation to that company (within the meaning given for that group of Parts by that section).
- (3) The reference to particular functions of the Authority in section 2(4)(d) of the Financial Services and Markets Act 2000 (c.8) (general duties applying to determination of policy and principles for performing particular functions) does not include a reference to any of its functions under this Act.
- (4) In each of -
- (a) paragraph 17(1)(a) of Schedule 1 to that Act (fees chargeable by the FSA for meeting the expenses of carrying out its functions), and
 - (b) paragraph 19(1) of that Schedule (exemption from liability in damages),

the reference to the Authority's functions (within the meaning of that Schedule) includes a reference to the Authority's functions under this Act.

ANNEX B – PARTIAL REGULATORY IMPACT ASSESSMENT

Purpose and intended effect

The purpose of the draft clauses relating to unlimited insurers is to provide the Financial Services Authority (FSA) with a power to give a direction to an insurer which is an unlimited liability company preventing calls being made against the members of the company.

The intention behind this measure is to provide greater protection to the members of such insurance companies.

Benefits

The proposed draft clauses will provide greater protection to the members of an unlimited liability insurance company which is insolvent, likely to become insolvent or otherwise in financial difficulties.

Without this measure it is possible that in the event of a winding-up of such a company the members would be called upon to make a financial contribution to pay outstanding liabilities to other creditors.

The proposed legislation will enable the FSA to make a direction to a company preventing the making of a call (or extinguishing the liability to pay where such a call has already been made) where it appears to the FSA that it would be unjust in all the circumstances for a call to be made against members.

Business sectors affected

The proposed legislation only affects insurance companies which are incorporated as unlimited liability companies.

It is the Treasury's understanding that the Equitable Life Assurance Society is the only major company which meets this criteria. However, we understand that there are a small number of other unlimited liability insurance companies.

Costs

The implementation of these clauses is not expected to impose any additional costs on any company which might be issued with a direction under the draft legislation. Nor is it expected that any significant additional costs will be incurred by the FSA in making such directions.

Creditors of an unlimited liability insurer which becomes insolvent may be affected to the extent that they are unable to recover all the monies due to them because a direction issued under the legislation prevents the liquidator of the company making calls on the members.

These proposals will not affect charities and voluntary organisations (except to the extent that such bodies may be creditors of an insurer issued with a direction under the proposed legislation). Likewise small businesses will not be affected except to the extent that they are creditors of affected insurers – so no small business litmus test has been carried out.

Competition assessment

As noted in the section on business sectors affected there are only a very small number of unlimited liability insurance companies. The vast majority of insurers are companies limited either by guarantee or by shares – the members of such companies can only be called on in the event of insolvency to the extent of any guarantee given or any unpaid up portion of their shares.

The Treasury understand that it is very unlikely that any new insurers constituted on an unlimited liability basis will be authorised by the FSA.

The Treasury do not believe that this proposal will give rise to any additional costs for either new or established firms nor should it affect the structure of the market or the ability of firms to choose the price, quality, range or location of their products.

The Treasury, therefore, do not believe that this proposal has any competition effects.